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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 219

THE KENTUCKY TRUST COMPANY, EXECUTOR OF THE ESTATE OF MARTIN L. SCHMIDT, DECEASED, PETITIONER

v.

SELDEN R. GLENN, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion and findings of fact and conclusions of law of the District Court (R. 125-135, 145-146) are reported at 75 F. Supp. 865. The opinion of the Court of Appeals (R. 155-156) is reported at 172 F. 2d 863.

JURISDICTION

The judgment of the Court of Appeals was entered on February 15, 1949 (R. 155). A petition for rehearing was denied on March 14, 1949

(R. 175), and, on May 28, 1949, this Court extended to August 1, 1949, the time to file a petition for a writ of certiorari. The petition for a writ of certiorari was filed on July 29, 1949. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the taxpayer, as grantor of two trusts for the benefit of his two children, respectively, is taxable on the income therefrom under Section 22 (a) of the Internal Revenue Code and pertinent Treasury Regulations.

STATUTE AND REGULATIONS INVOLVED

These may be found in the Appendix, *infra*, pp. 13-20.

STATEMENT

On December 10, 1938, the decedent-taxpayer as grantor, executed and delivered to the Kentucky Title Trust Company, a Kentucky corporation,[1] two trust agreements naming that company as trustee. One trust was for the benefit of taxpayer's daughter, Martha K. Schmidt, age 22; the other was for taxpayer's son, Martin F. Schmidt, age 20. (R. 128.)

The trust instruments provided in substance as follows:[2] The properties described in schedules

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[1] The name of the trustee was subsequently changed to the Kentucky Trust Company. (R. 129.)

[2] These instruments (Joint Ex. 1-A; 2-B; R. 26-41), contain substantially identical provisions. The record citations below refer to provisions in the trust instrument executed for the use and benefit of taxpayer's daughter.

attached to the instruments were assigned, transferred and delivered to the trustee or its successors in trust as a trust estate for the beneficiaries. The trustee was to accumulate, invest, and reinvest the net income from the estate until the beneficiary of the respective trusts became 25 years of age and, thereafter, to distribute the net income as augmented by accumulated income to the beneficiary until he or she became 40 years of age, whereupon the trust was to cease and the estate to be distributed to the beneficiary in absolute ownership. (R. 26-27.)

In case of death of the beneficiary before he or she reached the age of 40, the respective trust estates should be divided and distributed to his or her living descendants, if any, or if none, in like manner to the living descendants of the taxpayer. However, if any of the descendants were under 21 years of age on the date of the beneficiary's death, the estate should be distributed in trust for their use and benefit until they became of age whereupon it should be distributed to them free of trust. (R. 27.)

Paragraph IV of the trust instrument reads in part as follows (R. 27-28):

> 1. During the lifetime of Donor, the Trustee is authorized, empowered and directed to lease, mortgage, pledge, sell, dispose of, invest and reinvest property so held by it, and to vote stocks, exchange one class of securities for another, and agree to compromises with refer-

> ence thereto only at such times and in such manner as may be authorized and directed by Donor in writing.

After taxpayer's death the trustee was to have certain enumerated powers with respect to investment and reinvestment of funds and disposal of the property, subject to approval as to change, reinvestment or compromise of the property by a committee composed of taxpayer's wife, brother and son. Taxpayer reserved the right during his lifetime to designate other persons to serve on the committee. (R. 28-31.) Under the instruments, taxpayer during his lifetime, and after his death, the beneficiaries, had the power to remove the trustee and to appoint a new trustee provided the substituted trustee should be a trust company or bank with trust powers, and a member of the Federal Reserve System having a capital stock of not less than $500,000 (R. 32). Taxpayer could assign, transfer and deliver to the trustee other property to be added to the corpora and thereafter held, administered and distributed for the uses and on the terms and conditions as set out (R. 32). It was provided that the agreement was intended to, and should be, irrevocable, and that the taxpayer thereby relinquished all rights in the trust estate and income therefrom "except the power to control investments, change the Trustee and the personnel of the Advisory Committee" (R. 33).

On the same day, pursuant to the terms of the trust instrument, taxpayer transferred 200 shares of the common stock of the Coca-Cola Bottling Company, of Louisville, Kentucky (hereinafter referred to as the Bottling Company), a Kentucky corporation, to the trustee under the trust for his daughter. A similar grant was made in reference to the trust for his son. These shares have at all times material hereto thereafter been registered in the trustee's names on the corporate books of the Bottling Company. (R. 128.) Similarly, taxpayer transferred 50 additional shares to each trust on December 28, 1940 (R. 128-129).

Taxpayer made no other additions to the corpus of either trust, and no withdrawal, reduction, or substitution has ever been made. Taxpayer paid gift taxes on both grants of stock. (R .129.)

During the period December 10, 1938, through December 31, 1941, taxpayer filed income tax returns with the Collector on a cash receipts and disbursements, calendar year basis. During the same period, the trustee filed income tax returns which reported the income of the trust and paid to the Collector the taxes thereon. From September 23, 1941, to December 31, 1941, the income of the trust for taxpayer's daughter was by the trust terms distributable to her, and she included such income in her return for the taxable year 1941, although the income was not actually distributed to her. (R. 129-130.)

During the taxable years involved, 1939, 1940 and 1941, taxpayer was, and had been for some years, president of the Bottling Company. He was also treasurer and manager of the company and in charge of sales and production. He and his wife and brothers held four out of the six directorships of the Bottling Company. One of taxpayer's brothers was secretary of the company. (R. 145.)

Taxpayer's son, beneficiary under one of the trusts, has been associated with the Bottling Company in various capacities since 1940, excluding his years of wartime naval service (R. 145).

During the taxable years involved, the Schmidt family owned two-thirds of the stock of the Bottling Company. The other third was owned by the Ewing, Hurlbut, and Neiland families of Chattanooga, Tennessee. (R. 145-146.)

Except for the stock of the Bottling Company, the securities held by the trusts (purchased out of accumulated income) were all of corporations and governmental units wholly independent of taxpayer and his family, being securities widely held and currently bought and sold in the market. A strict record of all investments and disbursements was kept by the trustee, which was and is a substantial financial institution. The initiative for the investment of trust funds came from the trustee's investment committee. The trustee reported each investment to the taxpayer and the taxpayer

approved each; he was never a stockholder or director of the trustee. (R. 146.)

Since the creation of the trusts, none of the stock in the Bottling Company constituting the corpora of the trusts has ever been voted, and no request has ever been made by taxpayer or anyone else that the trustee vote the stock (R. 131).

On December 13, 1944, the Commissioner of Internal Revenue advised taxpayer that deficiencies were to be assessed against him for 1939 of $22,972.71, for 1940 of $25,089.58, and for 1941 of $38,230, by reason of income derived under the trust agreements. Taxpayer paid the taxes and subsequently paid accrued interest on them. (R. 130.)

On April 19, 1945, taxpayer duly filed claims for refund of the additional taxes paid, and no action upon these claims having been taken by the Commissioner of Internal Reveue within six months, instituted suit in the District Court. Subsequently, the Commissioner notified taxpayer of the rejection of the several refund claims. (R. 130-131.)

Upon these facts, the District Court concluded that the Commissioner had properly assessed taxpayer with additional taxes, and dismissed taxpayer's complaint (R. 147). The Court of Appeals affirmed on appeal, and denied a petition for rehearing (R. 155-156, 175). Pending denial of the petition for rehearing, taxpayer died and

his executor, petitioner herein, was substituted as a party (R. 175).

ARGUMENT

1. Petitioner advances four grounds for certiorari: (1) that collection of the tax under the circumstances of this case is unconstitutional; (2) that the decision of the court below is in conflict with decisions of the Court of Appeals for the Second Circuit; (3) that the decision below is inconsistent with *Helvering* v. *Clifford,* 309 U. S. 331; and (4) that new Treasury Regulations immunize the decedent-taxpayer from tax on the trust income here involved (Pet. 9-10, 15-28).

Three of these grounds can be disposed of at the outset. The constitutional validity of the tax here imposed depends upon the extent of control retained by the taxpayer-grantor. That is a question turning on the particular facts of this case viewed in the light of a general principle decided in *Helvering* v. *Clifford,* 309 U. S. 331, which is not here challenged. To characterize the question as a constitutional one is, in this context, to say no more than that the decision of the court below is erroneous. That it is not, will be briefly shown in point 3, *infra,* pp. 11-12.

Effective with respect to tax years beginning on or after January 1, 1946, new regulations have been adopted by the Treasury in the field of income taxation falling within the compass of *Helvering* v. *Clifford,* 309 U. S. 331. The explicit purpose of these regulations was to "resolve the present difficulties of application by defining and specifying

those factors which demonstrate the retention by the grantor of such complete control of the trust that he is taxable on the income therefrom under section 22 (a)". See Appendix to petition for a writ of certiorari, p. 31. To ask this Court to resolve an asserted conflict of decisions in cases decided with respect to tax years before 1946 and without reference to the new Treasury Regulations is to ask this Court to intrude itself into the task of resolving "the present difficulties of application"—a function which has already been undertaken by the Treasury. The issuance of a writ of certiorari under these circumstances would, in the Government's view, be inconsistent with a proper regard for the appropriate limitations on this Court's exercise of its discretionary jurisdiction, and for the role of the Treasury as a regulatory quasi-legislative organ.

When this case is viewed in the light of the new regulations,[3] it is conceded that the sole question

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[3] These amended regulations by their terms do not apply to the tax years in question, since they apply only to years beginning on or after January 1, 1946. The policy of the Bureau of Internal Revenue concerning the administration of these regulations is set forth in Mim. 5968, 1946-1 Cum. Bull. 25, and Mim. 6156, 1947-2 Cum. Bull. 13. It is there stated that years prior to January 1, 1946, will be governed by Section 22 (a), Internal Revenue Code, without reference to the amended regulations. However, it will be the policy of the Bureau of Internal Revenue in cases which have not yet been determined involving years prior to January 1, 1946, and when no inconsistent claims prejudicial to the Government are asserted by trustees or beneficiaries, not to assert liability against the grantor under the general provisions of Section 22 (a), Internal Revenue Code, if the trust income is not taxable to the grantor under the amended regulations.

is whether the grantor's retained powers were held in a nonfiduciary capacity (Pet. 25-26). It is further conceded that the answer to that question depends "on all the terms of the trust and the circumstances surrounding its creation and administration." (Pet. 26). It is at once apparent that that is a question peculiar to this case alone and not one warranting review by this Court.

Thus, viewing taxpayer's petition in its most favorable light, there is no warrant for certiorari.

2. There is, in any event, no conflict of decisions. In *Kohnstamm* v. *Pedrick,* 153 F. 2d 506 (C. A. 2), the taxpayer-grantor controlled only 23 percent of the outstanding stock of the corporation. Of another 27 percent, he had joint control with apparently unrelated trustees, and the court concluded, therefore, that his retention of a power to vote the stock was insignificant. In this case, on the other hand, the Schmidt families owned two-thirds of the stock of the Bottling Company; taxpayer, his wife and brothers comprised two-thirds of the board of directors (R. 145-146). The families held similar two-thirds interests in two other similar companies not directly involved here (R. 67-68, 83-84). Had the taxpayer not reserved the right to vote and control the stock, the two-thirds family control would have been ended, a consequence which, the taxpayer's testimony shows, he deemed it important to avoid (R. 78-79, 84-85).[4]

[4] Under Kentucky law, it was necessary to secure a two-thirds vote of the stockholders for many purposes. For example: reduction or increase of corporate stock (Carroll's

In *Cushman* v. *Commissioner*, 153 F. 2d 510 (C. A. 2), a conflict with which was also asserted in *Shapero* v. *Commissioner*, 165 F. 2d 811 (C. A. 6), certiorari denied, 334 U. S. 844, upon which the court below relied, the taxpayer-grantor was also a trustee. The court found that the powers there retained by the grantor were retained in a fiduciary capacity. That, as we shall show, is not the situation here.

3. The controls retained by the taxpayer were sufficiently substantial and non-fiduciary as to make applicable the principle of *Helvering* v. *Clifford*, 309 U. S. 331. The district court found that the taxpayer-decedent's right to direct the investment and reinvestment of the trust corpus justified the tax treatment of him as the owner of the corpus (R. 134, 132). The grantor was not a trustee; nor did the trust instrument refer to the powers vested in him as fiduciary. As has been shown, it was important to the taxpayer that his family's control over the Bottling Company be retained (R. 78-79, 84-85). Under the trust instrument, he could determine the terms and conditions of sales and invest the proceeds of the sale in any securities of his choice without regard to the beneficiaries' particular interests (R. 126, 128). He had the power to remove the trustee at will without reason or cause,

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Kentucky Statutes, Annotated (Baldwin, 1936), § 553); division of stock into preferred, common, and deferred shares (§ 564-1); entrance into consolidations with other corporations (§ 555); amendment of articles of incorporation (§ 559). Current Kentucky law also so provides. See Kentucky Revised Statutes (1948), §§ 271.130, 271.140, 271.250, 271.280.

and to substitute another trust company (R. 127). The stocks in the trust were not listed or quoted on any exchange and had not been bought or sold (R. 84). The petitioner's difficulty is that it has failed to meet its burden of showing that the powers retained were retained in a fiduciary capacity.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1949.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 22.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.166-1. TRUSTS WITH RESPECT TO THE CORPUS OF WHICH THE GRANTOR IS REGARDED AS REMAINING IN SUBSTANCE THE OWNER.

* * * * *

(b) *Test of Taxability to Grantor.*—Section 166 defines with particularity instances in which the grantor is regarded as in substance the owner of the corpus by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this section the grantor is deemed to have retained

such power if he, or any person not having a substantial interest in the corpus or the income therefrom adverse to the grantor, or both, may cause the title to the corpus to revest in the grantor. A bare legal interest, such as that of a trustee, is never substantial and never adverse. If the title to the corpus will revest in the grantor upon the exercise of such power, the income of the trust is attributed and taxable to the grantor regardless of—

(1) whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend, or to appoint;

(2) whether the exercise of such power is conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event;

(3) the time at which the title to the corpus will revest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain to come;

(4) whether the power to revest in the grantor, title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both;

(5) when the trust was created.

But the provisions of section 166 are not to be regarded as excluding from taxation to the

grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Internal Revenue Code, similarly regarded as remaining in substance the owner of the corpus. The grantor is regarded as in substance the owner of the corpus, if, in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitively with the substantial incidents of ownership in the corpus.

In determining whether the grantor is in substance the owner of the corpus, the Internal Revenue Code has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used nor on the technical description which the law of property gives to the estate or interest transferred to the trustees or beneficiaries of the trust. In that determination, among the material factors are: The fact that the corpus is to be returned to the grantor after a specific term; the fact that the corpus is or may be administered in the interest of the grantor; the fact that the anticipated income is being appropriated in advance for the customary expenditures of the grantor or those which he would ordinarily and naturally make; and any other circumstance bearing on the impermanence and indefiniteness with which the grantor has parted with the substantial incidents of ownership in the corpus.

Thus, the grantor is regarded as being in substance the owner of the corpus, if, in any case, the trust amounts to no more than an ar-

rangement whereby the grantor, in the ordering of his affairs, finds it expedient to entrust for a period the title to, and custody or management of, certain of his property to a trustee, the income from such property to be used by the trustee during such period to make those expenditures which the grantor would customarily or ordinarily or naturally make and to which the grantor chooses to commit himself in advance, while the corpus is to be held intact, for return in due course to the grantor. In such a case, it is immaterial that, at the time of the creation of the trust, an irrevocable disposition or consummated gift was made of those property rights which consist of the right to the expected future income of the corpus for the specified period. On the other hand, if the grantor, incident to a definitive and permanent disposition of certain of his property, creates the trust in order to conserve the property, not for himself but for the donees, who will ultimately enjoy it, the provisions of sections 161, 162, and 163 are applicable.

For example, a grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John,

(A) for the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) for the term of a year and a day,

then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not having a substantial adverse interest in the disposition of the corpus or the income therefrom); or

(C) for the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor is regarded as having retained the substantial incidents of ownership with respect to the income-producing property since the corpus will or may once more revest in himself in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

If, however, the grantor strips himself of the substantial incidents or attributes of ownership in the corpus retained by him so that he ceases to be regarded as in substance the owner of the corpus, the income thereof realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161, 162 and 163.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the corpus or the income therefrom. If the power to revest title

in the grantor is vested in him in conjunction with such person, or is vested solely in such person, there is to be excluded in computing the net income of the grantor only the income of such part.

(c) *Income and Deductions.*—If the grantor is regarded as remaining in substance the owner of the corpus the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.22(a)-21 [as added by T. D. 5488, 1946-1 Cum. Bull. 19, and as amended by T. D. 5567, 1947-2 Cum. Bull. 9]. TRUST INCOME TAXABLE TO THE GRANTOR AS SUBSTANTIAL OWNER THEREOF.

* * * * *

(e) *Administrative Control.*—Income of a trust, whatever its duration, is taxable to the grantor where, under the terms of the trust or the circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Administrative control is exercisable primarily for the benefit of the grantor where—

* * * * *

(4) any one of the following powers of administration over the trust corpus or in-

come is exercisable in a nonfiduciary capacity by the grantor, or any person not having a substantial adverse interest in its exercise, or both: a power to vote or direct the voting of stock or other securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether such power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. For example, where the trust corpus consists of diversified stocks or securities of corporations the stock of which is not closely held and in which the holdings of the trust, either by themselves or in conjunction with the holdings of the grantor, are of no significance from the viewpoint of voting control, a power with respect to such stocks or securities held by a person who is not a trustee will be regarded as exercisable in a fiduciary capacity primarily in

the interests of the beneficiaries. Where the trust corpus consists of stock or securities of a closely held corporation, such a power may or may not, depending upon all the facts, be considered exercisable in a fiduciary capacity.

The mere fact that a power exercisable by the trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

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